

CHAPTER 2

INCREASE FAIRNESS FOR FAMILIES

Fair and simple taxation of the family unit is a vital component of the Administration proposals. The proposals would accomplish these goals by redefining the tax threshold and by simplifying and rationalizing the provisions affected by the composition of the family unit.

Families with income at or below the poverty level should not be subject to income tax. Thus, the level of income at which tax is first paid would be raised so that for most taxpayers it approximates the poverty level. This would be accomplished by raising the zero bracket amounts, relatively more in the case of heads of households, and doubling the personal exemption compared with its 1984 level. These proposed changes are designed to reflect differences in ability to pay taxes that result from differences in family size and composition. The working poor also would be protected by increasing the earned income credit and indexing it for inflation.

Special relief for the blind, elderly, and disabled would be consolidated in a single tax credit, and the existing child care credit would be replaced with a more appropriate deduction. In light of the flatter rate schedule, which increases work incentives for taxpayers generally, the two-earner deduction would be repealed.

INCREASE ZBA AND PERSONAL EXEMPTIONS

General Explanation

Chapter 2.01

Current Law

Individual income tax rates begin at 11 percent and progress to a top marginal rate of 50 percent. For nonitemizing taxpayers, no tax is imposed on taxable income up to the "zero bracket amount" (ZBA, also known as the "standard deduction"), which is \$2,390 for unmarried individuals and heads of households, \$3,540 for married couples filing joint returns and certain surviving spouses, and \$1,770 for married individuals filing separately. Generally, a taxpayer may elect to itemize deductions only if the total amount of deductions exceeds the applicable ZBA.

In computing taxable income, each taxpayer is entitled to a personal exemption of \$1,040 and to a dependency exemption of \$1,040 for each of the taxpayer's dependents. If the taxpayer is blind or 65 years of age or older, an additional personal exemption of \$1,040 is provided. On a joint return, each spouse is entitled to claim the applicable number of personal exemptions.

The ZBA and the amount deducted from income for each personal and dependency exemption are adjusted for inflation. The percentage increase in each amount equals the percentage increase in prices during the previous fiscal year, as measured by the consumer price index for all urban consumers.

Reasons for Change

The sum of personal and dependency exemptions plus the ZBA establishes a tax threshold below which a taxpayer's income is exempt from taxation. The current levels of the ZBA and the personal and dependency exemptions do not exempt from tax an amount necessary to maintain a minimum standard of living. Moreover, as family size increases, the cost of maintaining a minimum living standard increases more rapidly than the amount of income exempt from tax. For example, in 1986 a family of four generally would start paying tax when its income exceeds \$9,575, which is approximately \$1,825 below the poverty threshold for such families. By burdening poor families, the tax system makes their transition to prosperity more difficult. The tax system thus discourages family creation and weakens and limits those that are formed.

Because the current tax thresholds have not kept up with increases in incomes, the number of persons required to file returns has grown, along with the percentage of taxpayers forced to itemize deductions. The increase in the number of returns and of itemizers has placed

additional recordkeeping burdens on taxpayers and also has drained the resources of the Internal Revenue Service. These increased costs are frequently out of proportion to the amounts of tax involved.

The additional personal exemptions provided to the blind and the elderly provide the greatest tax benefit to those elderly and blind taxpayers with the highest incomes. Thus, they are not the most effective way of reducing the tax burden for the blind and elderly who are in need.

Proposal

The ZBA would be increased to \$2,900 for single returns, \$4,000 for joint and certain surviving spouse returns, \$2,000 for returns for married persons filing separately, and \$3,600 for head of household returns. The amount deductible for each personal and dependency exemption would be increased to \$2,000 for taxable years beginning on or after January 1, 1986, and would be indexed for inflation thereafter.

The additional exemptions for the blind and the elderly would be repealed, but special tax treatment for the elderly, blind, and disabled would be combined into a single tax credit. See Ch. 2.02.

Effective Date

The proposal would apply for taxable years beginning on or after January 1, 1986.

Analysis

Table 1 compares the proposed personal exemptions and ZBA amounts to those under current law for 1986. The personal exemption for taxpayers, spouses, and dependents for 1986 would be increased to \$2,000, compared to \$1,080 under current law (after indexing for inflation expected to occur in 1985). The zero bracket amounts for single returns, head of household returns, and joint returns also would increase, as shown on Table 1.

Although the additional exemptions for the blind and the elderly would be repealed, low-income elderly and blind persons would be eligible for the expanded credit for the elderly, blind, and disabled. When the proposed increase in the personal exemption is combined with the expanded credit, the tax-free income level for elderly and blind persons would increase. The expanded tax credit would ensure that the income of low-income elderly and blind individuals would be exempt from tax.

Table 2 compares tax-free income levels for 1986 under current law and the Administration proposals with poverty thresholds for households of different sizes and compositions. Under the Administration proposals, the tax-free income levels would be

increased for single persons and families of all sizes. For example, for 1986 the tax-free income level for a one-earner married couple with no dependents would increase from \$5,830 to \$8,000. A one-earner married couple with two children would pay no income tax unless its income exceeded \$12,798, assuming full use of the earned income credit. Under current law, the same family would pay tax on income above \$9,575.

Table 2 shows that the proposed increase in the personal exemption and zero bracket amounts would exempt from tax families in poverty. Although the gap between the tax-free income level and poverty threshold would be narrowed for single persons without dependents, the tax-free income level for such taxpayers would still be \$900 less than the poverty level in 1986. If the tax-free income level for single persons were raised further to close the gap, however, single persons who decided to marry would experience a tax increase or "marriage penalty." Moreover, since single persons frequently live with relatives or unrelated persons, comparison of the tax-free income level with the poverty threshold for such persons often is misleading. When the tax-free income level for single persons is combined with the tax-free income levels of parents or other household members, the combined tax-free income level may exceed the poverty level.

Table 2.01-1

**Comparison of Personal Exemption and ZBA for 1986
Under Current Law and the President's Proposal**

	Current Law 1/	Proposed Law
Personal exemption		
For taxpayers, spouses, and dependents (each)	\$1,080	\$2,000
For the blind and the elderly (each)	1,080	<u>2/</u>
Zero-bracket amount		
Single persons	2,480	2,900
Heads of households	2,480	3,600
Married couples	3,670	4,000

Office of the Secretary of the Treasury May 28, 1985

1/ Includes indexation for expected inflation.

2/ Replaced with expanded credit.

Table 2.01-2

**Comparison of the Poverty Threshold and the Tax-Free Income
Level for 1986 Under Current Law and the President's Proposal**

Status	Poverty Threshold	Tax-Free Income Levels	
		Current Law 1/	Proposed Law
Single persons without dependents	\$ 5,800	\$ 3,560	\$ 4,900
Heads of households with one dependent 2/	7,700	7,945	10,158
Married couples 3/	7,500	5,830	8,000
Married couples with two dependents 2/ 3/	11,400	9,575	12,798

Office of the Secretary of the Treasury May 28, 1985

1/ Includes expected indexation for inflation.

2/ Assumes full use of the earned income tax credit where applicable.

3/ Assumes one earner.

COMBINE TAX BENEFITS FOR ELDERLY, BLIND
AND DISABLED INTO EXPANDED CREDIT

General Explanation

Chapter 2.02

Current Law

Individuals aged 65 or over and certain disabled persons are eligible for a nonrefundable credit equal to 15 percent of a defined "base amount." The base amount for the credit is computed by reference to the individual's "initial base amount." For those aged 65 or over, the initial base amount is \$5,000 for a single person (or for a married couple filing jointly if only one spouse is aged 65 or over). If both spouses are 65 or older, the initial base amount is \$7,500 if they file a joint return and \$3,750 if they file a separate return and live apart at all times during the year.

The actual base amount for the credit is equal to an individual's initial base amount reduced by (i) the amount of nontaxable pension and annuity income (principally social security benefits) and most nontaxable disability payments, or (ii) one-half of the taxpayer's adjusted gross income in excess of \$7,500 (for single taxpayers), \$10,000 (for married couples filing joint returns), or \$5,000 (for married individuals filing separate returns). When applied to the elderly, the credit provides a compensating tax benefit to those individuals who receive little or no social security benefits and hence derive little or no advantage from the exemption of such benefits from tax.

Individuals under age 65 also may qualify for the credit if (i) they receive employer-provided disability income or other taxable disability income and (ii) they are (or are expected to be) totally disabled for at least one full year. For these individuals, the initial base amount is the lesser of such disability income or the initial base amount that would apply if they were elderly. In these cases, the credit provides individuals receiving taxable disability payments with treatment comparable to that provided for recipients of tax-free workers' compensation and veterans' disability payments.

Elderly, blind, and disabled taxpayers also receive preferential treatment in other sections of the Internal Revenue Code. A taxpayer is allowed an additional personal exemption upon attaining age 65, and an additional exemption if he or she is blind. Each exemption reduces taxable income by \$1,080 for 1986. In addition, most disability income is untaxed, including workers' compensation, black lung payments, veterans' disability payments, and personal injury awards. Finally, social security benefits (including social security

disability income) are excluded from income unless the taxpayer's adjusted gross income (with certain modifications) exceeds \$25,000 (\$32,000 in the case of a joint return); in no event are more than one-half of such benefits included in income.

Reasons for Change

The preferential treatment applicable to elderly, blind, and disabled taxpayers recognizes the special hardships and costs such individuals encounter. Certain of the preferences available to such taxpayers under current law, however, provide the greatest benefit to those least in need. Thus, the additional personal exemptions for the elderly and blind provide the greatest benefit to those of the elderly and blind with the highest incomes. A \$1,080 exemption is worth \$540 to an individual in the 50 percent tax bracket, but only \$216 to an individual in the 20 percent tax bracket. There is no justification for this disparity.

In contrast, the current credit for the elderly targets its assistance to those with the greatest need. Because of the dollar-for-dollar offset for social security benefits, the credit provides no benefit to those who receive the average level of social security benefits. Moreover, because the credit is phased out as income increases, it provides the greatest benefit to low-income taxpayers. The credit for taxable disability payments operates in the same manner, and thus similarly targets its benefits to low-income taxpayers.

Finally, the current credit for employer-provided disability income encourages the recharacterization of retirement income as disability income (for those retiring before age 65), since the latter is eligible for the credit.

Proposal

The current special tax benefits for the elderly, blind, and disabled would be combined in a single credit, similar to the current credit for the elderly and disabled. All newly taxable disability income (workers' compensation and black lung) would be made eligible for the credit. To restrict recharacterization of normal retirement income as disability income, employer-provided disability income would be eligible for the credit only if provided under a qualified plan.

The amount of the credit would be calculated in the same manner as under current law. The initial base amount for the blind and those over 65 would be \$7,000 (in the case of single taxpayers or taxpayers filing joint returns that include only one blind or elderly taxpayer), \$11,500 (in the case of joint returns where both spouses are blind or over 65), \$8,750 (in the case of heads of households who are either blind or over 65), or \$5,750 (in the case of a married individual filing a separate return who is either blind or over 65 and has lived

apart from his or her spouse for the entire year). Limits on the amount of employer--provided disability income eligible for the credit would be increased to identical levels.

The income level at which the credit begins to phase out would be increased to \$11,000 (for single taxpayers), \$14,000 (for joint returns), \$12,500 (for heads of household), or \$7,000 (for married individuals filing separate returns).

Both the initial base amounts and the income levels at which the credit begins to phase out would be indexed for inflation, beginning in 1987.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986. Only taxable disability income would be eligible for the credit. The Administration proposals would require taxation of most workers' compensation and black lung payments received on or after January 1, 1987. Thus, with respect to such payments, the proposal generally would be effective on or after January 1, 1987.

Analysis

Table 1 compares the tax-exempt thresholds for the elderly and blind under current law and the Administration proposal. When combined with the proposed increase in their personal exemptions (to \$2,000 in 1986), the expansion of the credit for the elderly, blind, and disabled would increase their tax-exempt thresholds, despite the elimination of their additional exemptions. The tax-exempt levels shown in the table are far in excess of those for taxpayers generally.

The proposal would provide more equitable treatment for the elderly and blind and would also reduce artificial distinctions between sources of disability income. The effect of extending the credit to other forms of disability income is discussed more fully in Ch. 3.07, relating to proposed changes in the taxation of workers' compensation and black lung benefits.

Table 2.02-1

**1986 Tax-Free Levels of Income for the Elderly and Blind
(And Those With Employer-Provided Disability Income)**

	Single		Joint (Couple)	
	Current Law	Proposed Law	Current Law	Proposed Law
Ordinary Taxpayer	\$ 3,560	\$ 4,900	\$ 5,830	\$ 8,000
Age 65 or More <u>1/</u>				
No Social Security	9,383	11,600	14,450	17,667
Average Social Security <u>2/</u>	10,640	11,900	18,990	19,500
Blind <u>1/</u>				
No Social Security	4,640	11,600	7,990	17,667
Average Social Security <u>2/</u>	10,640	11,900	18,990	19,500
Under Age 65, with Employer- Provided Disability Income (\$6,000 single/\$9,000 joint)	9,383	10,400	14,450	15,333

Office of the Secretary of the Treasury

May 28, 1985

1/ For joint returns, assumes both are elderly/blind.2/ Benefits of \$6,000 (single) or \$11,000 (joint).

REPEAL TWO-EARNER DEDUCTION

General Explanation

Chapter 2.03

Current Law

The progressive tax rate structure of current law often results in higher tax rates for couples whose incomes are combined as a consequence of marriage. This result contributes to the so-called "marriage penalty," i.e., the increase in a couple's aggregate tax liability that may occur due to their marriage. The marriage penalty is ameliorated in part by the joint return rate schedule, under which married couples are taxed at lower rates than a single person with the same amount of taxable income. Because of the joint return rate schedule, marriage can result in a reduction of tax liability for some couples. Whether marriage actually results in a tax penalty or "bonus" depends principally on the total amount of a couple's taxable income and the percentage of such income attributable to each spouse.

To limit the marriage penalty, current law provides a special deduction for married couples in which both spouses earn personal service income. Thus, two-earner married couples who file joint returns may deduct from gross income the lesser of \$3,000 or ten percent of the qualified earned income of the spouse with the lower qualified earned income for the taxable year.

Reasons for Change

The current deduction for two-earner married couples is poorly designed to offset the increased tax liabilities that some couples face as a result of marriage. The deduction does not eliminate the marriage penalty for many couples, and for some it provides a benefit that exceeds any increase in tax liability caused by marriage. For still others, the deduction merely increases an existing marriage bonus. Moreover, because the deduction applies only to earned income, it has no effect when the marriage penalty arises from investment income.

The marriage penalty under current law is attributable primarily to the progressive rate structure and to the joint return concept, under which a married couple's income is aggregated for tax purposes. Abandonment of the joint return system would eliminate the marriage penalty, but would reintroduce a host of questions concerning how a couple's income and deductions are to be allocated between spouses. Moreover, taxing a married couple on the same basis as two single persons with equivalent combined income ignores that married couples frequently pool their incomes and may benefit from shared living expenses. An equally direct but better conceived response to the

marriage penalty is to reduce marginal tax rates, which at current high levels may discourage labor force participation or reduce the number of hours worked by second earners (typically married women).

Proposal

The deduction for two-earner married couples would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The Administration proposals include flatter tax rate schedules and lower marginal tax rates. In general, these changes would reduce the significance of tax consequences in individual decisions and improve incentives for taxpayers to work and invest. Since the tax structure would retain a degree of progressivity, as well as joint return treatment for married couples, the Administration proposals would not eliminate the possibility of a marriage penalty, nor, for that matter, of a marriage bonus. They represent, however, a more direct and consistent attempt to minimize the impact of marriage on tax liabilities than the current two-earner deduction.

Repeal of the two-earner deduction would eliminate Schedule W and one line from Form 1040 and seven lines from Form 1040A.

INCREASE AND INDEX EARNED INCOME TAX CREDIT

General Explanation

Chapter 2.04

Current Law

An eligible individual is allowed a refundable credit against income tax equal to 11 percent of the first \$5,000 of earned income. The maximum credit of \$550 is reduced by an amount equal to 12 2/9 percent of the excess of adjusted gross income ("AGI") or earned income (whichever is greater) over \$6,500. Thus, the credit is eliminated when AGI or earned income reaches \$11,000. Earned income eligible for the credit includes wages, salaries, tips, and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment.

An individual is eligible for the earned income credit only if the individual lives in the United States and (1) is married, files a joint return, and is entitled to a dependency exemption for a child living with the taxpayer, (2) is a surviving spouse, or (3) is the head of a household and entitled to a dependency exemption for a child living with the individual for more than one-half of the taxable year.

The maximum credit amount and the AGI or earned income limits are not indexed for inflation.

Reasons for Change

The earned income credit serves as an offset to social security and income taxes and provides work incentives for many low-income families with dependents. However, inflation has reduced the value of the credit. Moreover, increases in income attributable to inflation have reduced the number of families eligible for the credit and the amount of the credit for many of those who remain eligible.

The Tax Reform Act of 1984 reduced the inflation-caused decrease in the value of the credit and in the credit's availability by increasing the credit percentage, maximum credit, and income limit for the credit. The new amounts, however, are not indexed and will remain fixed until changed by legislation.

In order to provide some compensation for the effect of inflation on the value of credit and on the number of families eligible for the credit, the credit percentage should be increased, and the credit should phase out at a higher income level. To eliminate the need for periodic legislative adjustments in the credit, the maximum earned income credit amount and the AGI or earned income limit should be indexed to the rate of inflation.

Proposal

The earned income credit would be increased to 14 percent of the first \$5,000 of earned income. The maximum credit of \$700 would be reduced by 10 percent of the excess of AGI or earned income (whichever is greater) over \$6,500. Thus, the credit would be eliminated when AGI or earned income reaches \$13,500. Beginning in 1986, the maximum earned income credit and the AGI or earned income limit would be adjusted for inflation. The amount of the adjustment in a given calendar year would depend on the percentage increase in consumer prices for the previous fiscal year, as measured by the consumer price index for all-urban consumers ("CPIU").

Effective Date

The proposal would apply for taxable years beginning on or after January 1, 1986. Adjustments in inflation for 1986 would be based on changes in the CPIU for the 1985 fiscal year.

Analysis

In 1983, earned income tax credits totalling \$1.8 billion were claimed on individual income tax returns. The increase in the credit percentage and extension of the credit would provide an additional offset for social security and income taxes and a work incentive for many low-income families with dependents. Indexation of the earned income credit would ensure that inflation-induced increases in incomes would not reduce the credit for some low-income families and exclude other low-income families from eligibility. For example, assume that an eligible taxpayer earning \$6,500 in 1985 receives a four percent increase in income in 1986 and that inflation also equals four percent during the same period. Although the taxpayer's nominal income has increased, his or her "real" income (i.e., income adjusted for inflation) has stayed the same. Under current law, however, the taxpayer's earned income credit would fall from \$550 in 1985 to \$518 in 1986, because nominal income has increased. The real value of the credit, in 1985 dollars, would be only \$497. Under the proposal, the credit percentage would be increased to 14 percent and, assuming that inflation was four percent during fiscal year 1985, the earned income limit and maximum credit would be increased by four percent for 1986. Thus, the taxpayer would be eligible for a credit of \$728, the inflation-adjusted value of the maximum credit.

REPLACE CHILD AND DEPENDENT CARE CREDIT WITH DEDUCTION

General Explanation

Chapter 2.05

Current Law

A nonrefundable credit is allowed to an individual who pays employment-related child and dependent care expenses provided the individual maintains a household for one or more "qualifying individuals." In general, a qualifying individual is (1) a dependent of the taxpayer who is under the age of 15 and for whom the taxpayer can claim a dependency exemption, (2) a dependent of the taxpayer who is physically or mentally incapable of taking care of himself or herself, or (3) a spouse of the taxpayer if the spouse is physically or mentally incapable of taking care of himself or herself.

Dependent care expenses are considered to be employment-related only if they are incurred to enable the taxpayer to work and are paid for household services and the care of one or more qualifying individuals. Expenses for household services include the performance of ordinary and usual maintenance in the household, provided the expenses are attributable in part to the care of a qualifying individual. Thus, amounts paid for the services of a maid or cook qualify for the credit if part of the services performed are provided for a qualifying individual.

The amount of employment-related expenses that is eligible for the credit is subject to both a dollar limit and an earned income limit. Employment-related expenses are limited to \$2,400 for one qualifying individual and \$4,800 for two or more qualifying individuals. Further, employment-related expenses generally cannot exceed the earned income of the taxpayer, if single, or, for married couples, the earned income of the spouse with the lower earnings. Married couples must file a joint return to claim the credit.

Taxpayers with adjusted gross incomes of \$10,000 or less are allowed a credit equal to 30 percent of eligible employment-related expenses. For taxpayers with adjusted gross incomes of \$10,000 to \$28,000, the credit is reduced by one percentage point for each \$2,000 or fraction thereof above \$10,000. The credit is limited to 20 percent of employment-related child and dependent care expenses for taxpayers with adjusted gross incomes above \$28,000.

Reasons for Change

Child and dependent care expenses incurred in order to obtain or maintain employment affect a taxpayer's ability to pay tax in much the same manner as other ordinary business expenses. A family with

\$30,000 of income and \$2,000 of employment-related child care expenses does not have greater ability to pay tax than one with \$28,000 of income and no such expenses.

There is, of course, a personal element in dependent care expenses incurred for household services and the care of one or more qualifying individuals. No practical standards exist, however, for allocating child and dependent care expenses based upon the personal and business benefits derived. Moreover, the cost of dependent care is frequently substantially higher than other mixed business/personal expenses for which no deduction is allowed, such as the cost of commuting and of most business clothing. Disallowance of all dependent care costs in the computation of taxable income thus could generate a significant work disincentive.

Allowance of a deduction rather than a credit is the appropriate treatment of costs incurred in producing income. The current credit for dependent care expenses is targeted for the benefit of low-income taxpayers, although these expenses reduce the ability to pay tax at all income levels. Tax relief for low-income taxpayers is provided best through adjustments in tax rates or in the threshold level of income for imposition of tax. Such changes benefit all similarly situated taxpayers.

Computation of the limits on the dependent care credit, which vary with the taxpayer's adjusted gross income, also adds to the complexity of the tax law.

Proposal

A deduction from gross income would be provided for qualifying child and dependent care expenses up to a maximum of \$2,400 per year for taxpayers with one dependent, and \$4,800 per year for taxpayers with two or more dependents. Qualifying expenses would continue to be limited by the taxpayer's earned income, if single, or, in the case of married couples, by the earned income of the spouse with the lower earnings.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986.

Analysis

The proposal recognizes that child and dependent care expenses constitute legitimate costs of earning income. The extent to which such expenses also provide a personal benefit, however, varies in each situation. As with certain other expenditures that provide mixed business and personal benefits to taxpayers, such as business meal expenses, the proposal sets a dollar limitation on the amount allowed as a deduction.

Under the proposal, approximately six million families (6.5 percent of all families) would claim deductions for dependent care expenses totalling approximately \$8 billion. Approximately 60 percent of these deductions would be claimed by families with economic incomes under \$50,000. The deduction, however, is relatively less favorable to low-income families than is the current credit. The choice of the deduction reflects the view that progressivity should be provided directly through the personal exemptions and the rate structure.